

# **Audit**



# **Report**

OFFICE OF THE INSPECTOR GENERAL

**DEFENSE FINANCE AND ACCOUNTING  
SERVICE WORK ON THE FY 1994 AIR FORCE  
DEFENSE BUSINESS OPERATIONS FUND  
FINANCIAL STATEMENTS**

Report No. 96-021

November 6, 1995

**Department of Defense**

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### **Acronyms**

AFAA	Air Force Audit Agency
CFO	Chief Financial Officer
DBOF	Defense Business Operations Fund
DFAS	Defense Finance and Accounting Service
FASAB	Federal Accounting Standards Advisory Board
IG	Inspector General
GAO	General Accounting Office
OMB	Office of Management and Budget
SFFAS	Statement on Federal Financial Accounting Standards



**INSPECTOR GENERAL**  
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November 6, 1995

**MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)**  
**DIRECTOR, DEFENSE FINANCE AND ACCOUNTING**  
**SERVICE**

**SUBJECT: Audit Report on Defense Finance and Accounting Service Work on the**  
**FY 1994 Air Force Defense Business Operations Fund Financial**  
**Statements (Report No. 96-021)**

We are providing this audit report for review and comment. We conducted the audit in connection with the requirements of the Chief Financial Officers Act. Management comments on a draft of this report were considered in preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. Therefore, we request that the Under Secretary of Defense (Comptroller) and the Director, Defense Finance and Accounting Service Denver Center, provide comments on the unresolved recommendations by January 8, 1996.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. David C. Funk, Audit Program Director, at (303) 676-7445 (DSN 926-7445), or Mr. Thomas J. Winter, Audit Project Manager, at (703) 604-8978 (DSN 664-8978). The distribution of this report is in Appendix E. The audit team members are listed on the inside back cover of this report.

Robert J. Lieberman  
Assistant Inspector General  
for Auditing

# Office of the Inspector General, Department of Defense

Report No. 96-021

(Project No. 4FD-2015.01)

November 6, 1995

## Defense Finance and Accounting Service Work on the FY 1994 Air Force Defense Business Operations Fund Financial Statements

### Executive Summary

**Introduction.** This audit was performed as a result of the Chief Financial Officers Act of 1990. The Chief Financial Officers Act requires the Inspector General, DoD, or an independent auditor appointed by the Inspector General, DoD, to audit the financial statements of DoD activities. We delegated the Air Force portion of the audit of the FY 1994 financial statements of the Defense Business Operations Fund to the Air Force Audit Agency, and this audit supported their effort. We relied on the audit by the Air Force Audit Agency in developing our report on the Defense Business Operations Fund Consolidated Financial Statements. This report addresses the compilation and consolidation by the Defense Finance and Accounting Service (DFAS) Denver Center of the financial information, adjustments, and reporting activities of the Defense Business Operations Fund business areas. The Air Force financial statements were combined with other Military Department and Defense agency statements to produce the overall Defense Business Operations Fund financial statements.

**Audit Objective.** The overall audit objective was to assess the compilation and consolidation by the DFAS Denver Center of information supporting the Statement of Financial Position for the Air Force Defense Business Operations Fund. Our audit work complemented the Air Force Audit Agency financial statement audits of the Air Force Defense Business Operations Fund for FY 1994. We assessed related internal controls and compliance with laws and regulations for accounts determined to be material on the Air Force Defense Business Operations Fund Statement of Financial Position. We also evaluated the procedures that the DFAS Denver Center used to prepare the consolidated statements.

**Audit Results.** The DFAS Denver Center has made progress in accurately compiling and consolidating information for the Air Force financial statements, including the development of needed policies and procedures. However, we were unable to render an opinion on the Defense Business Operations Fund Consolidated Financial Statements because of material internal control deficiencies. In most cases, these deficiencies prevented us from assessing compliance with applicable laws and regulations. During the audit at the DFAS Denver Center, we identified two conditions warranting management action.

- o The Excess, Obsolete, and Unserviceable line of the "Inventory, Net" footnote of the Air Force Defense Business Operations Fund Consolidated Financial Statements was overstated by \$9.43 billion. The overstatement occurred because the line item contains inventory that should be categorized as Held for Repair, rather than unserviceable. Additionally, the footnote incorrectly indicated that all inventory values were adjusted to the latest acquisition cost. The correct valuation would be net realizable value for Excess, Obsolete, and Unserviceable inventory. As a result, the financial statements do not fairly represent inventory by category for the year ended September 30, 1994, (Finding A).

o At the DFAS Denver Center, the eliminating entry for intrafund accounts payable was not justified based on sufficient supporting information. As a result, the \$176.6 million entry made to eliminate intrafund accounts payable could not be verified and there is no basis for determining whether the entry was correct. This lack of sufficient supporting information impaired preparation of fairly presented financial statements (Finding B).

**Summary of Recommendations.** We recommend that the Under Secretary of Defense (Comptroller) rewrite the "Guidance on Form and Content of Financial Statements for FY 1994/1995 Financial Activity" on accounting for inventory and intrafund eliminations to agree with prevalent accounting practices. We also recommend that the DFAS Denver Center implement any revised guidance issued by the Under Secretary of Defense (Comptroller) on inventory and intrafund accounts payable by establishing and maintaining subsidiary ledgers that can be reconciled to support adjustments.

**Management Comments.** The Under Secretary of Defense (Comptroller) either partially concurred or nonconcurred with our recommendations. The Under Secretary of Defense (Comptroller) stated that sufficient guidance regarding accounting for inventory is already contained in the DoD guidance. He also stated that the existing accounting systems are unable to provide the information necessary to comply with prevalent accounting practices for eliminating entries.

The Deputy Director for Business Funds, Defense Finance and Accounting Service, either partially concurred or nonconcurred with our recommendations. The Deputy Director for Business Funds stated that a new general ledger account has been established to record inventory which is excess, obsolete, and beyond repair. He also stated that policy and systems changes are required to establish separate subsidiary accounts for payables and receivables, and until such changes are implemented and in operation throughout DoD, the current DoD Form and Content Guidance must remain in effect. A discussion of the management comments is in Part I and the complete text of management comments is in Part III.

**Audit Response.** The Under Secretary of Defense (Comptroller) comments were partially responsive. The recommendations were intended to strengthen DoD accounting policy so that compliance with accounting principles and practices can be improved. By updating accounting policy for inventory and eliminating entries, the Under Secretary of Defense (Comptroller) can increase the likelihood that more accurate and meaningful financial statements will be prepared by the DoD. Accordingly, we request the Under Secretary of Defense (Comptroller) provide additional comments on the recommendations by January 8, 1996.

The Deputy Director for Business Funds, Defense Finance and Accounting Service, comments were partially responsive. Until policy changes are implemented by the Under Secretary of Defense (Comptroller) to improve accounting for unserviceable inventory, the establishment of the new account is an improvement. The creation of this new account by the Defense Finance and Accounting Service indicates that procedures in addition to the existing Under Secretary of Defense (Comptroller) guidance are necessary to accurately account for Excess, Obsolete, and Unserviceable inventory. The Deputy Director for Business Funds did not address our second recommendation regarding the establishment of an accounts payable subsidiary ledger. Accordingly, we request that the Director, Defense Finance and Accounting Service Denver Center, provide additional comments by January 8, 1996.

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## **Part I - Audit Results**

### Audit Background

Public Law 101-576, the Chief Financial Officers Act of 1990 (CFO Act), requires the annual preparation and audit of Government financial statements. The Defense Finance and Accounting Service (DFAS), Denver Center, was responsible for preparing the FY 1994 consolidated statements for the Air Force Defense Business Operations Fund (DBOF) business areas. The business area statements include Supply Management, Distribution Depot<sup>1</sup>, Base Support, Transportation, and Depot Maintenance. Those financial statements represent the Air Force component of the overall DBOF financial statements.

In FY 1993, the Air Force DBOF reported assets of \$38.6 billion and revenues of \$12.5 billion. As of September 30, 1994, the Air Force DBOF reported assets of \$36.2 billion and revenues of \$13.4 billion.

The Inspector General (IG), DoD, is required to ensure the financial statements are audited. The IG, DoD, has delegated the responsibility for auditing the Air Force DBOF financial statements to the Air Force Audit Agency (AFAA). According to the IG, DoD, audit plan, the Statement of Financial Position was reviewed for FY 1994. The IG, DoD, assisted the AFAA by reviewing the compilation and consolidation of the financial statements by the DFAS Denver Center. This report discusses the results of our audit work at the DFAS Denver Center. The AFAA has issued three audit reports concerning internal controls and compliance with laws and regulations for accounts on the Statement of Financial Position within the Air Force DBOF business areas. The AFAA has also issued one audit report on the Air Force Defense Business Materiel Accounting System.

Air Force management is responsible for establishing and maintaining an internal control structure. To fulfill this responsibility, management must make estimates and judgments to assess the expected benefits and related costs of the internal control policies and procedures. The objective of an internal control structure is to provide management with reasonable assurance that obligations and costs are in compliance with applicable laws; that funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and that revenues and expenditures are properly recorded and accounted for.

The Federal Accounting Standards Advisory Board (FASAB) is studying accounting principles that will apply to Government financial statements. Generally accepted accounting principles for Federal agencies are to be promulgated by the Comptroller General, the Office of Management and Budget

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<sup>1</sup>The Distribution Depot business area was liquidated at the end of FY 1993. The DFAS Denver Center prepared financial statements for this business area only for comparative purposes, as required by OMB Bulletin 94-06, "Form and Content of Agency Financial Statements."

(OMB), and the Secretary of the Treasury, based on recommendations from the FASAB. The FASAB has issued three Statements on Federal Financial Accounting Standards and one Statement on Federal Financial Accounting Concepts. For issues not addressed in these four statements, Federal agencies are to follow the hierarchy established in OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 1993. This hierarchy is:

- o individual standards agreed to and published by the principals of the Joint Financial Management Improvement Program;

- o form and content requirements included in OMB Bulletin No. 93-02, "Form and Content of Agency Financial Statements," October 22, 1992, and subsequent issuances;

- o accounting standards contained in agency accounting policy, procedures manuals, and related guidance as of March 29, 1991, so long as they are prevalent practices; and

- o accounting principles published by authoritative standard-setting bodies and other authoritative sources, in the absence of other guidance in the first three parts of this hierarchy, and if the use of such accounting standards improves the meaningfulness of the financial statements.

The summary of significant accounting policies included in the consolidated footnotes describes the accounting standards prescribed by DoD Manual 7720.9-M, the "DoD Accounting Manual," which were used to prepare the FY 1994 financial statements.

The DoD has historically used revolving funds to provide services and supplies to its operating components. The revolving funds were established under title 10, United States Code, section 2208, "Working Capital Funds," and implemented by DoD Directive 7420.13, "Stock Fund Operations," January 27, 1983, and the DoD Accounting Manual. Individual revolving funds were combined into the DBOF on October 1, 1991, to serve customers more efficiently and effectively. The following is a description of each of the DBOF business areas operated by the Air Force.

- o The Supply Management business area manages and accounts for inventories of supplies, and generated 76 percent of the Air Force total DBOF revenues for FY 1994. This business area also collects and controls the costs of inventory and distribution depot management.

- o The Base Support business area consists of the Laundry and Dry Cleaning Service, which uses Government-owned facilities to provide laundry, dry cleaning, and other textile services to the Government, DoD, and other authorized activities worldwide.

- o The Transportation business area comprises the Air Mobility Command transportation responsibilities that are unique to the Air Force. These responsibilities include the Executive travel mission, the use of operational support aircraft, the air weather service, associated training, base

## Audit Results

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operations of the Air Mobility Command, tanker operations, and other functions. This business area was established during FY 1993 and was disestablished beginning in FY 1995, in accordance with the DBOF improvement plan.

- o The Depot Maintenance business area includes depot-level repair, maintenance, and overhaul of weapon system components and other major items.

## Audit Objective

The overall audit objective was to assess the compilation and consolidation by the DFAS Denver Center of information supporting the Statement of Financial Position for the Air Force Defense Business Operations Fund. Our audit work complemented the AFAA financial statement audits of the Air Force Defense Business Operations Fund for FY 1994. Specifically, we performed reviews and tests to assess the accuracy of financial data. We assessed related internal controls and compliance with laws and regulations for accounts determined to be material on the Air Force Defense Business Operations Fund Statement of Financial Position. We also evaluated procedures that the DFAS Denver Center used to prepare the consolidated statements. This audit was performed at the DFAS Denver Center during the period of August 1994 through May 1995.

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## Finding A. Disclosure in Inventory Footnote

The dollar value reported for Excess, Obsolete, and Unserviceable inventory in the Inventory, Net, footnote of the Air Force DBOF Consolidated Financial Statements was materially overstated by \$9.43 billion, while Inventory Held for Repair was understated by \$9.48 billion. The value of the inventory may be misinterpreted because the footnote indicates that inventory values were adjusted to the latest acquisition cost. Additionally, the DFAS Denver Center did not disclose the criteria used for identifying the category to which inventory is assigned. These conditions occurred because DFAS Denver Center personnel followed DoD guidance that did not require the same information required by Statement on Federal Financial Accounting Standards (SFFAS) Number 3, "Accounting for Inventory and Related Property," and OMB Bulletin No. 94-01. As a result, the financial statements do not fairly present inventory by category for the year ended September 30, 1994.

### Criteria for Inventory Footnote

**OMB Standard.** In October 1993, the OMB issued SFFAS Number 3, which provides accounting standards for inventory and five other assets of the Federal Government and its entities. The statement defined the elements of excess, obsolete, and unserviceable inventory.

"Excess Inventory" is inventory stock that exceeds the demand expected in the normal course of operations because the amount on hand is more than can be sold in the foreseeable future and that does not meet management's criteria to be held in reserve for future sale. "Obsolete Inventory" is inventory that is no longer needed due to changes in technology, laws, customs, or operations. "Unserviceable Inventory" is damaged inventory that is more economical to dispose of than repair.

The SFFAS Number 3 requires such inventory to be valued and reported in financial statements at its expected net realizable value. The difference between the carrying amount of the inventory before identification as excess, obsolete, or unserviceable, and its expected net realizable value, is to be recognized as a loss.

**OMB Requirements for Form and Content of Statements.** OMB Bulletin No. 94-01 lists seven required disclosures for the Inventory, Net, footnote, which were first established in SFFAS Number 3. These required disclosures include:

- o the balances for four categories of inventory, one of which is Excess, Obsolete, and Unserviceable inventory;

## Finding A. Disclosure in Inventory Footnote

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- o the basis for determining inventory values, including the valuation method; and

- o the criteria for identifying the category to which inventory is assigned.

These disclosures give readers of the financial statements a more complete understanding of the components of the Inventory, Net, line of the Statement of Financial Position. The criteria indicate how management determined the classification of inventory in the footnote. This allows comparison of the inventory composition of different DBOF components.

**DoD Guidance on Form and Content of Statements.** The DoD Comptroller issued "Guidance on the Form and Content of Agency Financial Statements for FY 1994/1995 Financial Activity" (DoD Form and Content Guidance) in October 1994. It provides guidance for preparing the financial statements and related footnotes for DoD activities. The guidance requires three parts for the Inventory, Net, footnote. Part A of the footnote is required to disclose the acquisition cost of the inventory, the allowance for losses on inventory, the net book value of the inventory, and the method used to value the inventory. Part B of the footnote describes any restrictions on the use, sale, or disposition of inventory. Part C of the footnote is to provide any other information relative to inventory not disclosed in Part A or Part B. However, the DoD Form and Content Guidance did not specifically require the disclosure of the criteria for assigning inventory to the four categories.

**DFAS Guidance.** An October 7, 1994, memorandum from DFAS-HQ/AB, "Adjustment Factors for Use in Adjusting Inventory Values to Latest Acquisition Cost for Fiscal Year 1995," established the factors to be used when revaluing inventory. The DFAS determined that the net realizable value of disposal stock was 2 percent of the latest acquisition cost for financial statements as of September 30, 1994.

## Presentation of Footnote

**Inventory Categorization.** The dollar value reported for excess, obsolete, and unserviceable inventory was overstated by \$9.43 billion in the Air Force DBOF FY 1994 financial statements. The DFAS Denver Center reported \$29.62 billion of inventory in the Air Force DBOF FY 1994 Statement of Financial Position. The Inventory, Net, footnote included \$12.61 billion categorized as Held for Current Sale; \$9.53 billion categorized as Excess, Obsolete, and Unserviceable; and \$7.48 billion categorized as Held for Repair. The amount identified as Excess, Obsolete, and Unserviceable contains \$9.43 billion in inventory that should be categorized as Held for Repair. This condition occurred due to the different definitions of unserviceable inventory within the Air Force and OMB. The OMB definition states that unserviceable items should be disposed of rather than repaired. The Air Force definition includes items held for repair, so a discrepancy exists in the financial statement presentation. Further, the Held for Current Sale category includes \$52 million

## Finding A. Disclosure in Inventory Footnote

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and the Held for Repair category includes \$14 million of inventory that is Excess, Obsolete, and Unserviceable. The adjusted value of the Excess, Obsolete, and Unserviceable inventory that has been identified for disposal should be approximately \$101 million. The Inventory Valuation section provides the details for the information used in the table.

### Inventory Categorization (millions)

<u>Inventory Category</u>	<u>Reported Amount</u>	<u>Adjusted Amount</u>
Inventory Held for Current Sale	\$12,610	\$12,558
Excess, Obsolete, and Unserviceable Inventory	9,533	101
Inventory Held for Repair	<u>7,480</u>	<u>16,964</u>
<b>Total</b>	<b>\$29,623</b>	<b>\$29,623</b>

**Inventory Valuation.** The SFFAS Number 3 requires that Excess, Obsolete, and Unserviceable inventory be valued at net realizable value in the financial statements. The Inventory, Net, footnote states that the inventory values, including Excess, Obsolete and Unserviceable inventory, are adjusted to the latest acquisition cost. This presentation is misleading because \$101 million of the \$29.62 billion reported as inventory was valued at net realizable value. This \$101 million is the net realizable value of \$5.03 billion of inventory identified as Excess, Obsolete, and Unserviceable.

The DFAS Denver Center routinely prepares entries to reduce inventory identified as Excess, Obsolete, and Unserviceable to its net realizable value. For the fiscal year ending September 30, 1994, the DFAS Denver Center determined that \$5.03 billion of inventory was Excess, Obsolete, and Unserviceable. Because of a rounding error, the DFAS Denver Center used \$5.07 billion as the basis for the adjustment to revalue the inventory. The DFAS Denver Center prepared four entries totaling \$4.97 billion (\$5.07 billion multiplied by 0.98) to make this adjustment, and the financial statements reflect this loss.

The accounts that compose the Held for Current Sale and Held for Repair lines of the footnote contained \$3.30 billion of inventory that was determined to be Excess, Obsolete, and Unserviceable. The other \$1.73 billion was related to the account that composed the Excess, Obsolete, and Unserviceable line of the footnote.

The \$4.97 billion adjustment reduced the value of the account that composes the Excess, Obsolete, and Unserviceable line of the footnote by \$1.69 billion, and

## Finding A. Disclosure in Inventory Footnote

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inappropriately reduced the values of accounts that compose the Held for Current Sale and Held for Repair lines of the footnote by \$3.28 billion. As a result of this adjustment, the Excess, Obsolete, and Unserviceable line of the footnote contains \$34.4 million (\$1.72 billion multiplied by 0.02) and the Held for Current Sale and Held for Repair lines contain \$66 million (\$3.30 billion multiplied by 0.02) of inventory valued at net realizable value.

The Excess, Obsolete, and Unserviceable line of the footnote should be valued at net realizable value. Using the DFAS factor, the net realizable value of the inventory identified as Excess, Obsolete, and Unserviceable should be \$101 million (\$5.03 billion multiplied by 0.02). The remaining \$9.43 billion (\$9.53 billion minus \$101 million) of inventory shown on the Excess, Obsolete, and Unserviceable line of the footnote should be distributed to the Held for Repair line of the footnote. Table 1 shows the reported distribution of inventory among the footnote categories and the correct distribution.

**Disclosure in Footnote.** The DFAS Denver Center did not meet all disclosure requirements of SFFAS Number 3 and OMB Bulletin No. 94-01 for the Inventory, Net, footnote. The Inventory, Net, footnote meets the specific disclosure requirements of the DoD Form and Content Guidance; however, this guidance does not require the same disclosures required by SFFAS Number 3 and OMB Bulletin No. 94-01.

The additional information disclosed by the DFAS Denver Center in Part C of the footnote was limited to an explanation of the valuation method used for the inventory. The DFAS Denver Center did not disclose the criteria used to assign inventory among the four categories shown in the footnote. Disclosure of such criteria is a requirement of SFFAS Number 3 and OMB Bulletin No. 94-01, but is not specifically addressed in the DoD Form and Content Guidance. Disclosure should have identified a conflict between the criteria used to categorize inventory in the Air Force DBOF Financial Statements and the criteria in SFFAS Number 3 for Excess, Obsolete, and Unserviceable inventory, reducing the likelihood of misinterpretation by readers of the financial statements.

**Loss on Revaluation.** The revaluation of Excess, Obsolete, and Unserviceable inventory to net realizable value results in a loss of 98 percent of the value of the inventory. The DFAS Denver Center valued inventory categorized as Excess, Obsolete, and Unserviceable at \$9.53 billion and stated that this inventory was valued using the latest acquisition cost method. If this were the case, the loss on revaluation to the net realizable value would be \$9.34 billion (\$9.53 billion multiplied by 0.98) rather than the reported loss of \$4.97 billion.

## Recommendations, Management Comments, and Audit Response

**A.1.** We recommend that the Under Secretary of Defense (Comptroller) modify the DoD "Guidance on Form and Content of Agency Financial Statements for FY 1994/1995 Financial Activity" to:

a. Define inventory categorized as Excess, Obsolete, and Unserviceable and require that such inventory be valued at net realizable value in the footnotes to the financial statements.

**Management Comments.** The Under Secretary of Defense (Comptroller) partially concurred and stated that the appropriate guidance already is included in Chapter 7 of the DoD Form and Content Guidance. This guidance states that "An allowance for the cost of repair will be provided for in determining the value of unserviceable inventory items. In preparing FY 1994/95 financial statements, the value of unserviceable inventory items will be decreased by the amount of repair costs."

**Audit Response.** The Under Secretary of Defense (Comptroller) comments were partially responsive. The recommendation is intended to eliminate the discrepancy between the definitions of Excess, Obsolete, and Unserviceable inventory established in SFFAS Number 3 and the definitions used by the DoD financial community. As stated in the finding, SFFAS Number 3 defines unserviceable inventory as damaged inventory that is more economical to dispose of than repair. The Under Secretary of Defense (Comptroller) comments indicate that the DoD considers inventory that is economically feasible to repair to be unserviceable inventory, which the DoD holds should be valued net of repair cost. Including items for repair in unserviceable inventory does not provide a meaningful representation of the account, and illustrates how the lack of a clear definition can lead the DoD financial community to incorrectly classify and value inventory. By clearly defining Excess, Obsolete, and Unserviceable inventory and requiring valuation at net realizable value, the Under Secretary of Defense (Comptroller) can reduce the possibility of incorrect classification and valuation of inventory. We request that the Under Secretary of Defense (Comptroller) reconsider his position and provide additional comments in response to this final report.

b. Require disclosure of the criteria for identifying the category to which inventory is assigned.

**Management Comments.** The Under Secretary of Defense (Comptroller) partially concurred and stated that both Under Secretary of Defense (Comptroller) and Defense Finance and Accounting Service instructions require specific methods of valuation for separate categories of materiel. There is no value in issuing additional guidance to correct the conditions cited in the finding because existing, applicable guidance was not followed.

**Audit Response.** The Under Secretary of Defense (Comptroller) comments were not responsive. The comments addressed inventory valuation rather than

## **Finding A. Disclosure in Inventory Footnote**

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our recommendation concerning disclosure. The SFFAS Number 3 and OMB No. 94-01 address the disclosure requirements of inventory. The DoD Form and Content Guidance does not require the same disclosures specified in SFFAS Number 3 and OMB Bulletin No. 94-01. By implementing this recommendation, the disclosure requirements of the DoD Form and Content Guidance will be the same as the disclosure requirements specified by OMB Bulletin No. 94-01. We request that the Under Secretary of Defense (Comptroller) provide comments that address this recommendation.

**A.2. We recommend that the Director, Defense Finance and Accounting Service Denver Center, implement the revised DoD "Guidance on Form and Content of Agency Financial Statements for FY 1994/1995 Financial Activity" for inventory reporting when the revised guidance is issued.**

**Management Comments.** The Deputy Director for Business Funds, Defense Finance and Accounting Service partially concurred and stated that a new general ledger account has been established to record inventory which is excess, obsolete, and beyond repair.

**Audit Response.** The Defense Finance and Accounting Service comments were responsive. Until policy changes are implemented by the Under Secretary of Defense (Comptroller) to improve accounting for unserviceable inventory, the establishment of the new account is an improvement. However, the new account should be consistent with the definitions of Excess, Obsolete, and Unserviceable inventory established in SFFAS Number 3.

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## Finding B. Elimination of Accounts Payable

The DFAS Denver Center based the entry eliminating \$176.6 million of intrafund accounts payable on insufficient supporting information. This condition occurred because the general ledger accounting system did not maintain subsidiary ledgers that identified intrafund accounts payable, and the DoD "Guidance on Form and Content of Agency Financial Statements for FY 1994/1995 Financial Activity" did not provide adequate guidance for preparing eliminating entries. As a result, the entry made to eliminate intrafund accounts payable could not be verified and there is no basis for determining whether the entry is correct. This condition can impair preparation of fairly presented financial statements.

### Intrafund Eliminations

**Intrafund Transactions.** Intrafund transactions occur when sales are made or services are rendered between entities whose financial information composes the same consolidated financial statements. An example of an intrafund transaction would be a sale from the Air Force DBOF Supply Management business area to the Air Force DBOF Transportation business area. When such a transaction occurs, intrafund accounts payable and accounts receivable often result. Because consolidated statements are based on the assumption that they represent the financial position and operating results of a single entity, such statements should not include accounts receivable or accounts payable resulting from transactions among subentities in the group. Therefore, intrafund transactions and balances should be eliminated in the preparation of financial statements, in accordance with generally accepted accounting principles. As DoD moves toward the goal of Government-wide financial statements as specified in Public Law 103-356, "Government Management Reform Act," October 13, 1994, eliminating entries will become more critical.

**Prevalent Practices.** Chapter 11 of the DoD Accounting Manual requires that accounting systems identify transactions that would be eliminated for intra-agency consolidations. In its discussion of eliminations of intrafund transactions, General Accounting Office (GAO) Title 2, "Policy and Procedures Manual for Guidance of Federal Agencies - Accounting," August 1987, states that appropriate accounting records must be maintained to determine the eliminations. For accounts payable, appropriate accounting records would include an accounts payable subsidiary ledger that identifies the entity to which the payable is owed.

**DoD Guidance on Eliminations.** The DoD Form and Content Guidance does not give adequate instructions for preparing eliminating entries. The instructions for Note 29, "Intrafund Eliminations," state that the selling activity will identify the intrafund accounts receivable, and that it is presumed that an equal amount of accounts payable has been entered on the accounting records of

## **Finding B. Elimination of Accounts Payable**

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the purchasing activities; consequently, those amounts should be eliminated from the DoD Component principal statements. Because the AFSA has consistently reported that accounting data from field activities are inadequate, the DFAS Denver Center should not presume that equal amounts of accounts receivable and accounts payable have been recorded by the seller and buyer. This is not a prevalent accounting practice outside of DoD, and prevents reconciliation of the accounting records of the selling and purchasing activities. For proper accounting, both entries must be identified before eliminating the payables.

**DFAS Denver Center Procedures.** The DFAS Denver Center did not use accounts payable data to compute the eliminating entry for intrafund accounts payable; this entry was based entirely on accounts receivable data provided by the field activities. For FY 1994, this amount was \$176.6 million.

The DFAS Denver Center receives accounts payable and accounts receivable data from Air Force DBOF field activities. The accounts receivable data include sales code numbers that identify the entity from which the receivable is due. The accounts payable subsidiary accounts identify only the Service to which the account is payable. They are not detailed enough to determine whether the payable is owed to an Air Force DBOF subentity or outside activity. For example, a receivable owed by another Air Force DBOF subentity would be identified as such in the accounts receivable subsidiary accounts; however, a payable owed to another Air Force DBOF subentity would be identified only as a payable owed to the Air Force in the accounts payable subsidiary accounts. As a result, the DFAS Denver Center is unable to reconcile the intrafund accounts receivable with detailed data on accounts payable to confirm the accuracy of the eliminating entry.

By using only accounts receivable data to determine the amount to be eliminated, the DFAS Denver Center was not following prevalent accounting practices. As a result, we were unable to verify the accuracy of the adjustment made to eliminate intrafund accounts payable.

## **Recommendations, Management Comments, and Audit Response**

**B.1.** We recommend that the Under Secretary of Defense (Comptroller) revise the DoD "Guidance on Form and Content of Agency Financial Statements for FY 1994/1995 Financial Activity" to require that adjustments to eliminate intrafund accounts payable be based on a reconciliation of accounts payable and accounts receivable information.

**Management Comments.** The Under Secretary of Defense (Comptroller) nonconcurred and stated that currently, there is no means to reconcile DBOF Accounts Receivable at one DBOF Component and Accounts Payable at another Component because Accounts Payable amounts are identified by Government and Non-Government. Currently, there is no mechanism to identify the entities

## Finding B. Elimination of Accounts Payable

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to which the payables are owed. Until policy and system changes are implemented and in operation throughout the Department, the current DoD form and content guidance must remain in effect.

**Audit Response.** The Under Secretary of Defense (Comptroller) comments were nonresponsive. As currently written, the DoD Form and Content Guidance states that when eliminating intrafund transactions, the DoD community should presume that equal amounts of payables and receivables have been recorded on the books of the buyer and seller. This is not a prevalent accounting practice because all accounts must be supported by valid transactional data, and may distort the financial statements.

The Under Secretary of Defense (Comptroller) comments indicated that over the long term, policy and system changes are required to more accurately classify Accounts Payable. We agree that such changes are needed, however, we do not agree that changes to the DoD Form and Content Guidance should occur after the necessary policy and system changes. By allowing deficient accounting practices to meet agency guidance, the incentive for the DoD community to change the accounting systems to provide the necessary data is lost. With the current DoD Form and Content Guidance, the DoD community could incorrectly presume they are in conformance with accepted accounting policy. However, they are not meeting the requirement of prevalent accounting practices. Only through a change by the Under Secretary of Defense (Comptroller) can the problem be recognized by DoD. We request that the Under Secretary of Defense (Comptroller) reconsider his position and provide additional comments to this final report.

**B.2. We recommend that the Director, Defense Finance and Accounting Service Denver Center, establish and maintain an accounts payable subsidiary ledger that will allow identification of intrafund eliminations.**

**Management Comments.** The Deputy Director for Business Funds, Defense Finance and Accounting Service, nonconcurred with the recommendation. He stated that, until policy and system changes to establish separate subsidiary accounts for payables and receivables are implemented throughout the Department, the current DoD Form and Content Guidance must remain in effect.

**Audit Response.** The Defense Finance and Accounting Service comments were not responsive. The comments are identical to those submitted by the Under Secretary of Defense (Comptroller) and address the recommendation for policy changes rather than the recommendation for establishing an accounts payable subsidiary ledger.

We request the Director, DFAS to comment on the feasibility of implementing an accounts payable subsidiary ledger into the planned accounting system changes contracted for under the Interim Migratory Accounting System project. Expected completion dates for actual implementation are also requested.

## **Part II - Additional Information**

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## Appendix A. Scope and Methodology

### Scope and Methodology

**Methodology.** We performed this financial-related audit during the period of August 1994 through May 1995, in accordance with generally accepted Government auditing standards issued by the Comptroller General of the United States as implemented by the IG, DoD, and OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993. Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial information presented in the consolidated statements is free of material misstatements. Computer-processed data were used to support the Statement of Financial Position; we determined that the data were unreliable because the reconciliations necessary for a non-transaction-driven general ledger were not performed. This deficiency was previously reported to DFAS managers, who are taking corrective actions. We did not use statistical sampling in our audit because of the unreliable data and because the records at the DFAS Denver Center were not sufficiently detailed.

In planning our audit tests, we considered the related internal control structure. We obtained an understanding of the internal control policies and procedures and assessed the level of risk in processing transactions for account balances. We also evaluated whether significant control policies and procedures had been properly designed and were operating effectively, and we reviewed management controls as necessary.

**Limitation on Scope.** To support the AFSA in its audit of the Air Force portion of the DBOF, we performed audit work related to those functions performed by the DFAS Denver Center. Other organizations contacted are listed in Appendix D. In accordance with the IG, DoD, audit plan for FY 1994, we limited our review to the Statement of Financial Position. The information used to prepare the financial statements was obtained from trial balance data transmitted to the DFAS Denver Center from Air Force locations worldwide. We did not evaluate the accuracy of the data provided by outside sources. We evaluated the DFAS Denver Center's procedures for ensuring data accuracy and completeness.

### Management Control Program

DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987, requires DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

**Scope of Review of Management Control Program.** We reviewed the adequacy of the DFAS Denver Center controls over accounts on the Statement of Financial Position to determine whether they were properly reported on the financial statements, and whether management complied with laws and regulations having a direct and material effect on the financial statements. We also reviewed the results of any self-evaluation of those controls.

**Adequacy of Management Controls.** We identified material internal control weaknesses for the DFAS Denver Center as defined by DoD Directive 5010.38. Internal controls did not ensure the accurate presentation of financial information in the footnotes to the financial statements. Weaknesses in internal controls resulted in high levels of risk, and also resulted in instances of noncompliance and misstatements that affected the DBOF business area and the consolidated statements.

Our recommendations, if implemented, will correct the internal control weaknesses related to the presentation of the Inventory, Net, footnote in the Air Force DBOF financial statements. The monetary benefits to be realized by implementing the recommendations were not identifiable because of the lack of internal controls and the lack of reliable data generated by the financial systems. Other benefits resulting from this audit are detailed in Appendix C, "Summary of Potential Benefits Resulting from Audit." A copy of the report will be provided to the senior official responsible for internal controls within the DFAS.

**Adequacy of Management's Self-Evaluation.** The program was in place, but internal control weaknesses existed that had not been reported. The management control program did not detect the weaknesses because the program questionnaire did not cover the preparation of the footnotes or eliminating entries.

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## Appendix B. Prior Audits and Other Reviews

The GAO issued audit reports in FYs 1990 and 1992 on the Air Force financial statements, and the IG, DoD, performed six recent financial audits. Also, the AFAA performed 28 audits on the FY 1992 Air Force financial statements and 30 audits on the FY 1993 financial statements. The audits listed below apply specifically to this report.

**General Accounting Office.** GAO Report No. AFMD-90-23 (OSD Case No. 8193-A), "Air Force Does Not Effectively Account for Billions of Dollars of Resources," was issued in February 1990. The principal findings were that financial systems did not provide reliable financial data, basic internal control weaknesses existed, the full costs of weapon systems were not identified, and inventory systems did not provide accurate data. The Under Secretary of Defense (Comptroller) concurred with all 26 recommendations. The GAO recommended that the Air Force make better use of existing financial information, develop more accurate financial information, perform reconciliations and document adjustments, account for the costs of weapon systems, achieve financial management of inventories, and develop a new accounting system.

GAO Report No. AFMD-92-12 (OSD Case No. 8376-L), "Aggressive Actions Needed for Air Force to Meet Objectives of the CFO Act," was issued in February 1992. The report's principal findings were that financial systems were not integrated and generated unreliable information, the reported costs of weapon systems were unreliable, accounting and controls over the Air Logistics Command inventories were inadequate, internal accounting controls were inadequate, and short-term actions were needed to improve the quality of financial data and allow completion of a financial statement audit. GAO Report No. AFMD-92-12 reaffirmed the 26 recommendations in the GAO February 1990 report, and made additional recommendations to improve management accountability, strengthen internal controls, improve the quality of financial information, and assist the Air Force in meeting the objectives of the CFO Act.

**Inspector General, Department of Defense.** IG, DoD, Audit Report No. 95-267, "Defense Business Operations Fund Consolidated Statement of Financial Position for FY 1994," was issued on June 30, 1995. The auditors were unable to render an opinion on the Consolidated Statement of Financial Position. The report cited the lack of a sound internal control structure for the DBOF and significant deficiencies in the accounting systems.

IG, DoD, Audit Report No. 95-072, "Defense Finance and Accounting Service Work on the FY 1993 Air Force Defense Business Operations Fund Financial Statements," was issued on January 11, 1995. This audit determined that the DFAS Denver Center used negative inventory account data of \$300.5 million and negative Inventory in Transit data of \$1.1 billion to compute the inventory balances on the financial statements without performing adequate research into the causes of the negative balances. As a result, the FY 1993 statements may not have accurately represented the year-end financial position. The DFAS

## Appendix B. Prior Audits and Other Reviews

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Denver Center included the negative Inventory in Transit issue as a material internal control weakness in its annual statement of assurance. In addition, the DFAS Denver Center and the AFAA conducted a joint study to determine the causes of the negative Inventory in Transit balance. The DFAS Denver Center also improved its process for reviewing negative account data provided by the field activities.

IG, DoD, Audit Report No. 94-161, "Consolidated Statement of Financial Position of the Defense Business Operations Fund for FY 1993," was issued on June 30, 1994. We reported many internal control problems associated with four accounts of the DBOF financial statements. The main problems reported for the Fund Balance with Treasury account were the definition of the account and the reconciliation of the balances. The DoD definition of this account was not consistent with accounting principles, which made the balance misleading. Also, activities could not reconcile their own portions of the account because the information was integrated with the other DoD Fund Balance with Treasury information. Misstatements were reported for the Defense Logistics Agency and the Navy for this account. The Inventory Held for Sale, Net, account and Inventory Not Held for Sale account also had many problems. In addition to valuation and classification problems, material discrepancies were found for this account with many activities. Specifically, for the Inventory Not Held for Sale account, negative inventory balances were reported, and the accuracy of War Reserve Assets could not be verified. Finally, the Army and the Air Force did not maintain appropriate documentation for items included in the Property, Plant, and Equipment account, which made those portions of the account unauditable. Also, the Air Force did not report all Property, Plant, and Equipment in the DBOF financial statements. Additionally, the Property, Plant, and Equipment account for the Joint Logistics Systems Center was misstated because that activity had not implemented an effective internal control program.

IG, DoD, Audit Report No. 93-134, "Principal and Combining Financial Statements of the Defense Business Operations Fund - FY 1992," was issued on June 30, 1993. Material internal control weaknesses that affected the reliability of the DBOF financial statements for FY 1992 were reported. Transactions were not properly recorded and accounted for because controls over cash were inadequate, transactions by and for others were not recorded in a timely manner, there was no elimination or reporting of intrafund transactions, and certain accounts were not properly accounted for. We were unable to ensure that assets were safeguarded from unauthorized use because of the lack of supporting documentation, and because the capital asset and inventory accounts were not correctly valued and we could not determine their existence. The execution of transactions was not in compliance with existing guidance. Reconciliations, uniform accounting systems, and a standard general ledger were lacking, and the weekly flash cash reports were unreliable.

Several instances of noncompliance with laws and regulations materially affected the reliability of the DBOF financial statements for FY 1992. For FY 1992, the accounting systems for DBOF did not meet the requirements of the Budget and Accounting Procedures Act of 1950 and GAO Title 2, "Policy and Procedures Manual for Guidance of Federal Agencies." DBOF financial

## Appendix B. Prior Audits and Other Reviews

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statements did not fully comply with OMB Bulletin No. 93-02, "Form and Content of Agency Financial Statements," which implemented the Chief Financial Officers Act, and quarterly and annual reports to the U.S. Treasury on Accounts and Loans Receivable Due from the Public were not accurately prepared. The Air Force Supply Management business area did not follow requirements of the DoD Accounting Manual. Real properties were incorrectly shown as assets on the DBOF financial statements, and did not follow the guidance on Real Property Ownership in title 10 United States Code, section 2682. Finally, the DFAS Columbus Center and the Defense Commissary Agency did not adhere to the Prompt Payment Act. Because the report made no recommendations, management comments were not required. However, we received comments from the Acting Chief Financial Officer. Management generally agreed with the report, but took exception to our reportable conditions on inadequate audit trails and reported instances of noncompliance with the Budget and Accounting Procedures Act; GAO Title 2, "Policy and Procedures Manual for Guidance of Federal Agencies - Accounting"; OMB Bulletin No. 93-02; and the National Defense Authorization Act. We did not agree with management's comments.

**Air Force Audit Agency.** In FY 1995, the AFAA issued four audit reports related to Air Force DBOF financial accounting practices. The AFAA also issued four opinion reports on the FY 1993 DBOF financial statements.

The AFAA Audit Report, "Review of Selected Internal Controls and Compliance with Laws and Regulations for Assets and Liabilities Within the Supply Management Business Area, Fiscal Year 1994," Project No. 94068041, was issued on June 27, 1995. For the Supply Management business area, the AFAA found that internal controls over accounts payable, inventories, and property, plant, and equipment were not always effective, and that DFAS personnel did not always comply with the DoD Accounting Manual, regulations, and guidance from the Under Secretary of Defense (Comptroller).

The AFAA Audit Report, "Review of Internal Control and Management Issues Related to the Airlift Services Division of the United States Transportation Command Business Area, Fiscal Year 1994," Project No. 94068040, was issued on July 14, 1995. For the Airlift Services Division of the United States Transportation Command, the AFAA found that internal controls over assets and liabilities were not totally adequate, and that accounting personnel did not accurately report or support balances for accounts receivable; accounts payable; property, plant, and equipment; and selected liability and capital accounts. The AFAA also found that Air Mobility Command personnel and DFAS personnel did not always comply with regulations and guidance from the Under Secretary of Defense (Comptroller).

The AFAA Audit Report, "Review of Selected Internal Controls and Compliance with Laws and Regulations for Assets, Liabilities, and Net Position Within the Depot Maintenance Service Business Area, Fiscal Year 1994," Project No. 94068039, was issued on July 28, 1995. For the Depot Maintenance Service business area, AFAA found that internal controls over accounts receivable, accounts payable, operating spares and material, and property, plant, and equipment were not always effective, and that DFAS

## Appendix B. Prior Audits and Other Reviews

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personnel did not always comply with the DoD Accounting Manual, guidance from the Under Secretary of Defense (Comptroller), and other regulations.

The AFAA Audit Report, "Review of the Air Force Defense Business Materiel Accounting System, Reparable Support Division," Project No. 94068038, was issued on June 28, 1995. The AFAA audited Sales, Cost of Sales, and Accounts Receivable transactions in the new transaction-driven general ledger used to prepare Reparable Support Division Trial Balances. The AFAA found that the transaction-driven general ledger contained sufficient transaction references to supply source records of Air Force bases to permit the verification of reported account balances. However, the accounting system's retrieval capabilities and internal controls over system-identified errors were not effective.

The AFAA "Opinion on Air Force Defense Business Operations Fund, Fiscal Year 1993 Inventories Held for Sale Balance," Project No. 94068017, was issued on June 30, 1994. The AFAA was unable to render an opinion on the accuracy of Inventories Held for Sale. They could not determine whether the balance was accurately stated, and did not believe that the Air Force could rely on the internal control structure to ensure that Air Force DBOF Inventories Held for Sale were properly recorded. Further, the AFAA determined that existing systems and controls did not enable the Air Force and DFAS to fully comply with laws and regulations.

The AFAA "Opinion on Air Force Defense Business Operations Fund, Fiscal Year 1993 Inventories Not Held for Sale Balances," Project No. 94068018, was issued on June 30, 1994. The AFAA stated that the ending balance of Inventories Not Held for Sale was not presented accurately or in conformity with generally accepted accounting principles. Also, the AFAA did not believe that the Air Force could rely on the internal control structure to ensure that Air Force DBOF Inventories Not Held for Sale were properly recorded. Further, existing systems and controls did not enable the Air Force and DFAS to comply with various laws and regulations.

The AFAA "Opinion on Air Force Defense Business Operations Fund, Fiscal Year 1993 Property, Plant, and Equipment Balances," Project No. 94068019, was issued on June 30, 1994. The AFAA determined that the Air Force DBOF Statement of Financial Position did not present the value of Property, Plant, and Equipment accurately or in conformity with generally accepted accounting principles. Also, the AFAA did not believe that the Air Force could rely on the internal control structure to ensure that Air Force DBOF Property, Plant, and Equipment assets were properly recorded. In addition, existing systems and controls did not enable the Air Force and DFAS to comply with various laws and regulations.

The AFAA "Opinion on Air Force Defense Business Operations Fund, Fiscal Year 1993 Fund Balance With Treasury," Project No. 94068020, was issued on June 30, 1994. The AFAA was unable to render an opinion on the accuracy of the \$1.4 billion Fund Balance with Treasury amount reported on the Air Force DBOF Statement of Financial Position. The AFAA also did not believe that the Air Force could rely on the internal control structure to ensure that Air Force

## **Appendix B. Prior Audits and Other Reviews**

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DBOF Fund Balance with Treasury transactions were properly recorded. The AFAA determined that existing systems and controls did not enable the Air Force and DFAS to comply with various laws and regulations.

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## **Appendix C. Summary of Potential Benefits Resulting From Audit**

<b>Recommendation Reference</b>	<b>Description of Benefit</b>	<b>Type of Benefit</b>
A.1.	Compliance With Regulations or Laws. Establishes policies and procedures to meet reporting requirements of public law and directives.	Nonmonetary.
A.2.	Compliance With Regulations or Laws. Brings financial reporting into compliance with the requirements of public law and directives.	Nonmonetary.
B.1.	Management Controls. Improves auditability of financial statements and related financial data.	Nonmonetary.
B.2.	Management Controls. Provides the DFAS Denver Center with improved data for reporting purposes.	Nonmonetary.

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## **Appendix D. Organizations Visited or Contacted**

### **Office of the Secretary of Defense**

Under Secretary of Defense (Comptroller)  
Director, Financial Management Policy, Washington, DC

### **Department of the Air Force**

Assistant Secretary of the Air Force (Financial Management and Comptroller),  
Director of Budget Management and Execution, Washington, DC  
Air Force Audit Agency, Acquisition and Logistics Support Directorate,  
Wright-Patterson Air Force Base, OH

### **Defense Agency**

Defense Finance and Accounting Service, Arlington, VA  
Defense Finance and Accounting Service Center, Denver, CO

### **Non-Defense Organizations**

Federal Accounting Standards Advisory Board, Washington, DC  
U.S. General Accounting Office, Washington, DC

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## **Appendix E. Report Distribution**

### **Office of the Secretary of Defense**

Under Secretary of Defense for Acquisition and Technology  
Director, Defense Logistics Studies Information Exchange  
Under Secretary of Defense (Comptroller)  
Deputy Chief Financial Officer  
Director, Accounting Policy  
Director, Management Improvement  
Deputy Comptroller (Program/Budget)  
Assistant to the Secretary of Defense (Public Affairs)

### **Department of the Army**

Auditor General, Department of the Army

### **Department of the Navy**

Assistant Secretary of the Navy (Financial Management and Comptroller)  
Auditor General, Department of the Navy

### **Department of the Air Force**

Assistant Secretary of the Air Force (Financial Management and Comptroller)  
Director (Audit Liaison and Follow-up)  
Auditor General, Department of the Air Force  
Financial and Support Audits Directorate  
Acquisition and Logistics Audits Directorate

### **Other Defense Organizations**

Director, Defense Contract Audit Agency  
Director, Defense Finance and Accounting Service  
Director, Customer Service and Performance Assessment Deputate  
Director, Defense Finance and Accounting Service Denver Center  
Internal Review Office  
Director, Defense Logistics Agency  
Director, National Security Agency  
Inspector General, National Security Agency

## **Non-Defense Organizations**

Office of Management and Budget  
Technical Information Center, National Security and International Affairs Division,  
U.S. General Accounting Office

Chairman and ranking minority member of each of the following congressional committees and subcommittees:

Senate Committee on Appropriations  
Senate Subcommittee on Defense, Committee on Appropriations  
Senate Committee on Armed Services  
Senate Committee on Governmental Affairs  
House Committee on Appropriations  
House Subcommittee on National Security, Committee on Appropriations  
House Committee on Government Reform and Oversight  
House Subcommittee on National Security, International Affairs, and Criminal  
Justice, Committee on Government Reform and Oversight  
House Committee on National Security

## **Part III - Management Comments**

# Under Secretary of Defense (Comptroller) Comments



COMPTROLLER

OFFICE OF THE UNDER SECRETARY OF DEFENSE  
1100 DEFENSE PENTAGON  
WASHINGTON, DC 20301-1100



AUG 30 1995

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING, DoD

SUBJECT: Draft Audit Report on Defense Finance and Accounting Service Work on the  
FY 1994 Air Force Defense Business Operations Fund Financial Statements  
(Project No. 4FD-2015.01) dated July 24, 1995

This is the Office of the Under Secretary of Defense (Comptroller) response to recommendations A.1 and B.1 of subject draft audit report.

The additional guidance that is proposed in the recommendation A.1.(a) already exists. This office notes, however, that this existing guidance does not appear to have been followed in preparing the financial statements reviewed by the auditors. Therefore, additional guidance is not required, nor is it likely to be effective if existing guidance is not followed.

In addition, this office notes that recommendation B.1. appears to be based on an assumption regarding the recording of receivables and payables that is not reflective of actual practices. Therefore, this office requests that the recommendation and references to accounts receivable and accounts payable being created as a result of transactions between a seller (Air Force DBOF supply management activity) and a buyer (Air Force DBOF Transportation business area) be omitted from the report as not representative of billing and collecting procedures under the interfund billing system.

My point of contact on this guidance is Mr. Oscar G. Covell. He may be reached at (703) 697-6149.

Alvin Tucker  
Deputy Chief Financial Officer

Attachment

cc: Director, DFAS

DRAFT AUDIT REPORT ON  
DEFENSE FINANCE AND ACCOUNTING SERVICE  
WORK ON THE FY 1994 AIR FORCE  
DEFENSE BUSINESS OPERATIONS FUND FINANCIAL STATEMENTS  
(PROJECT NO. 4FD-2015.01) DATED JULY 24, 1995

★★★★★

RECOMMENDATIONS

**DODIG RECOMMENDATION A-1:** We recommend that the Under Secretary of Defense (Comptroller) modify the DoD "Guidance on Form and Content of Financial Statements for FY 1994/1995 Financial Activity" to:

- (a) Define inventory categorized as Excess, Obsolete, and Unserviceable and require that such inventory be valued at net realizable value in the footnotes to the financial statements.
- (b) Require disclosure of the criteria for identifying the category to which inventory is assigned.

**DODIG RECOMMENDATION A-2:** We recommend that the Director, Defense Finance and Accounting Service-Denver Center, implement the revised DoD "Guidance on Form and Content of Financial Statements for FY 1994/1995 Financial Activity" for inventory reporting when the revised guidance is issued.

**DoD RESPONSE:** Partially concur.

(a) The appropriate guidance already is included in Chapter 7 of the DoD "Guidance on Form and Content of Financial Statements for FY 1994/1995 Financial Activity" on page 7-5. This guidance states that—"An allowance for the cost of repair will be provided for in determining the valuation of unserviceable inventory items. In preparing FY 1994/95 financial statements, the value of unserviceable items will be decreased by the amount of repair costs. If an item of inventory is either not repairable or no longer applicable to the Department's needs, then the item will be valued at its anticipated net realizable cash value as either scrap or surplus material offered for sale to the public. The Department plans to fully disclose its methodology in an appropriate footnote to the financial statements." Note 8 to the financial statements requires that the valuation method be disclosed for each category of inventory.

(b) The recommendation does not match the facts of the case. The finding cites instructions, both USD(C) and DFAS, which require specific methods of valuation for separate categories of materiel. This guidance apparently was not followed by the preparers of the financial statement. There is no value in issuing additional guidance to correct the conditions cited in the finding since existing, applicable guidance was not followed.

**DODIG RECOMMENDATION B-1:** We recommend that the Under Secretary of Defense (Comptroller) revise the DoD "Guidance on Form and Content of Financial Statements for FY 1994/1995 Financial Activity" to require that adjustments to eliminate interfund accounts payable be based upon a reconciliation of accounts payable and accounts receivable information.

**DoD RESPONSE:** Nonconcur. Currently, there is no means to reconcile DBOF Accounts Receivable at one DBOF Component and Accounts Payable at another Component because Accounts Payable amounts are identified by Government and Non-Government. Within the government category, there is no identification whether the amounts are appropriated funds, Business Operations Funds, or amounts owed to another government agency. Over the long term, policy and system changes are required to identify more accurately amounts (1) within DBOF, (2) within DoD Component, (3) within DoD, and (4) with other government agencies. Until such changes are implemented and in operation throughout the Department, the current DoD form and content guidance must remain in effect.

# Defense Finance and Accounting Service Comments



## DEFENSE FINANCE AND ACCOUNTING SERVICE

1931 JEFFERSON DAVIS HIGHWAY  
ARLINGTON, VA 22240-5291

DFAS-HQ/AD

SEP 27 1995

MEMORANDUM FOR DEPUTY DIRECTOR, FINANCE AND ACCOUNTING  
DIRECTORATE, INSPECTOR GENERAL, DOD

SUBJECT: Draft Audit Report on Defense Finance and Accounting  
Service Work on the FY 1994 Air Force Defense Business  
Operations Fund Financial Statements (Project No. 4FD-  
2015.01) dated July 24, 1995

As requested in your memorandum dated July 24, 1995, subject  
as above, the following are our comments to the recommendations  
in the subject report directed to the Defense Finance and  
Accounting Service (DFAS):

Recommendation A.2. We recommend that the Director, Defense  
Finance and Accounting Service, implement the revised DoD  
"Guidance on Form and Content of Agency Financial Statements for  
FY 1994/95 Financial Activity" for inventory reporting when the  
revised guidance is issued.

DFAS Comments: Partially concur. Recommendation A.1. is to have  
the DoD Form and Content guidance modified to:

a) Define inventory categorized as Excess, Obsolete, and  
Unserviceable and require that such inventory be valued at net  
realizable value in the footnotes to the financial statements.

b) Require disclosure of the criteria for identifying the  
category to which inventory is assigned.

The appropriate guidance is already included in Chapter 7 of  
the DoD "Guidance on Form and Content of Financial Statements for  
FY 1994/1995 Financial Activity" on page 7-5. A new general  
ledger account has been established to record inventory which is  
excess, obsolete, and beyond repair. Although the published  
footnote cannot be revised for FY 1994, the deficiency has been  
corrected.

Recommendation B.2: We recommend that the Director, Defense  
Finance and Accounting Service establish and maintain an accounts  
payable subsidiary ledger that will allow identification of  
intrafund eliminations.

DFAS Comments: Nonconcur. Currently, there is no means to  
reconcile DBOF Accounts Receivable at one DBOF Component and  
Accounts Payable at another Component because Accounts Payable  
amounts are identified by Government and Non-Government. Within

the government category, there is no identification whether the amounts are appropriated funds, Business Operations Funds, or amounts owed to another government agency. Over the long term, policy and systems changes are required to establish separate subsidiary accounts for payables and receivables to identify (1) within DBOF, (2) within DoD Component, (3) within DoD, and (4) with Other Government Agencies. Until such changes are implemented and in operation throughout DoD, the current DoD Form and Content Guidance must remain in effect.

My point of contact is Mr. William J. deBardelaben on (703) 607-1581.



Edward A. Harris  
Deputy Director for Business Funds

## **Audit Team Members**

This report was produced by the Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, Department of Defense.

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